BRIEF IN SUPPORT OF PETITION.

Argument.

POINT I.

Section 36a of the New York Lien Law creates a particular statutory crime; it does not create new civil rights or remedies between a contractor and his materialmen.

This Court has held that the question as to whether a state statute is penal or not is one exclusively within the determination of the Court in which the action is then pending. Thus it was said in *Huntington* v. *Attrill,* 146 U. S. 657, at page 683:

> "In this country, the question of international law (is the law penal?) must be determined in the first instance by the court, state or national, in which the suit is brought. If the suit is brought in a Circuit Court of the United States, it is one of those questions of general jurisprudence which that court must decide for itself, uncontrolled by local decisions. *Burgess* v. *Seligman,* 107 U. S. 20, 33; *Texas & Pacific Railway* v. *Cox,* 145 U. S. 593, 605."

In accordance with the foregoing rule, petitioner presented to the Court below the question whether the New York statute was a penal statute and, therefore, not entitled to recognition or enforcement. The opinions of the Circuit Court contain no reference to this point, and no direct ruling was made thereon.

The precise question, however, was passed upon by the Circuit Court of Appeals, Sixth Circuit, in *Edward Misch Co.'s Estate,* 112 F. (2d) 1007, affirming 34 F. Supp. 781. There, a materialman sought to impress a trust on funds in the hands of the trustee in bankruptcy, pursuant to the Public Acts of Michigan, 1931, No. 259. The Michigan statute provided

> "Building contract fund; status as a trust fund. Section 1. In the building construction industry, the building contract fund paid by the owner to a contractor, or by the owner or contractor to a subcontractor, shall be considered by this act to be a trust fund, for the benefit of the owners, contractors, laborers, subcontractors or materialmen, and the said contractor or subcontractor shall be considered the trustee of all funds so paid to him for building construction purposes.
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> same; fraudulent detention or use by contractor or subcontractor, penalty. sec. 2. Any contractor or subcontractor engaged in the building construction business, who, with intent to defraud, shall retain or use the proceeds or any part therefor, of any payment made to him, for any other purpose than to first pay laborers, subcontractors and materialmen, engaged by him to perform labor or furnish material for the specific improvement, shall be guilty of felony in appropriating such funds to his own use while any amount for which he may be liable or become liable under the terms of his contract for such labor or material remains unpaid, and may be prosecuted * * * and upon conviction shall be punished by a fine * * * or * * * imprisonment * * * at discretion of the court."

In refusing to impress a trust, the Referee held that the Michigan statute was a penal one and did

not confer any civil rights or remedies. The determination of the Referee was affirmed unanimously by the Circuit Court of Appeals, Sixth Circuit.

A comparison of the Michigan statute with the New York statute indicates a complete similarity, except for phraseology. Both statutes declare the funds received by a contractor to be trust funds. Both require the contractor to pay the funds to his subcontractors and materialmen. Both likewise provide that a failure by the contractor to comply with the provisions of the statute constitutes a felony. Between the two statutes, there are more indications for holding the granting of a civil right or remedy under the Michigan statute, than under the New York statute. The New York statute consists of one sentence, containing two separate thoughts. The first declares the funds received by a contractor to be trust funds to be applied to the payment of materialmen and subcontractors; the second provides that any failure by the contractor to so apply the funds shall constitute a larceny. In the Michigan statute, these two thoughts are expressed as separate sections, numbered 1 and 2, consecutively. Standing alone, §1 clearly creates a civil right and remedy. Notwithstanding, such subdivision the Michigan Court held that the statute did not affect the civil rights and obligations existing between the contractor and his subcontractors or materialmen, but on the contrary, solely created a particular statutory crime. *Club Holding Co.* v. *Flint Citizens Loan & Investment Co.*, 272 Mich. 66, 261, N. W. 133. So too, in *Raymond Concrete* v. *Federation Bank & Trust Company*, 261 App. Div. 25, Dore, *J.*, in a dissenting opinion, held that §25a of the New York Lien Law (which is identical with §36a except that it applies to public im-

provements) was likewise penal in nature and punitive in character.

Further basis for the petitioner's contention that the New York statute was intended to create a new statutory crime is found in the report of the New York State legislative committee, when in 1930, it recommended an amendment to §25 of the Lien Law. The proposed amendment was the exact counterpart of §36a, except that it applied to public improvements. In proposing this amendment, the committee stated (Legal Document No. 72, 1930, Vol. 19, p. 23):

> "In order to strengthen the law the committee further recommended the penalty provided in subdivision (6) thereof, thus bringing the diversion of funds under this section in line with similar provisions contained in sections 36, 36a and 36b relating to diversion by an owner, contractor and subcontractor of funds on private improvements."

And, again, the same committee, in proposing 36a and 36b, said, at page 26:

> "Your committee in recommending the change from misdemeanor to larceny believes that in order to give proper protection against misapplication of funds, the law should be severe enough to be a real deterrent."

Nothing the committee could have said could have more adequately expressed their intention that the statute was penal than the expression "the law should be severe enough to be a real deterrent."

As a penal statute, the New York statute is complete. As a statute granting a civil right or remedy, as contended by the respondent herein, there is no

explanation for the following self-evident defects in the statute, if it be construed as granting civil rights:

The statute permits the contractor full freedom to enter into any compromise or settlement with the owner of the improvement, without consulting with the intended beneficiaries of the trust;

the statute permits the contractor to assign the trust funds without the consent of the intended beneficiaries. *Amiesite Construction Corp.* v. *Luciano Contracting,* 284 N. Y. 223;

the statute permits a judgment-creditor of the contractor to levy upon or attach the funds while in the hands of the owner of the improvement, *Amiesite Construction Corp.* v. *Luciano Contracting* (*supra*);

the statute permits the contractor to distribute the funds in any proportion he sees fit to the intended beneficiaries, instead of pro rata.

The foregoing deficiencies are such as to completely nullify any benefits that might have been intended by the statute were it designed to create civil rights. There is neither basis nor reason to assume that the legislators allowed these patent defects to exist if it were their intention to draft a statute conferring civil rights and remedies. The existence of these defects is only consonant with a finding that the statute was intended solely and exclusively as one creating a statutory crime.

The fact that the Courts of New York have given effect to this statute as one granting civil rights is not binding or controlling upon this Court, *Huntington* v. *Attrill* (*supra*).

POINT II.

The trust as intended by Section 36a of the New York Lien Law does not arise until, as a condition precedent, the funds come into or pass through the hands of the contractor.

Unlike similar statutes enacted in several of the other states, the New York statute specifically limits the trust to "funds received by a contractor * * * and * * * funds in the hands of such contractor."

At the time when this appeal was first submitted to the Circuit Court, there had as yet been no ruling by the Court of Appeals of the State of New York as to the scope of the foregoing phrase. There were, however, decisions of lower Courts which were submitted to the Circuit Court. The general tenor of these decisions was that none other than the contractor could be included in the *descriptio personae* under the various trust sections of the Lien Law. The Circuit Court, in its first opinion in this case, sought to distinguish these decisions on the ground that if the party receiving the funds had notice that it was a recipient of trust funds then such party was within the *descriptio personae* of the statute.

Subsequently, the question was presented to the Court of Appeals by the appellant in *Amiesite Construction Corp.* v. *Luciano Contracting* (*supra*). In that case, the appellant, a subcontractor who had failed to file a lien, was contesting the rights of the assignee of the general contractor to the funds in the possession of the state. It was argued by the appellant that by reason of §25a of the Lien Law, a trust was imposed on the funds for the primary benefit of the appellant as an unpaid subcontractor. (§25a, ap-

plicable to public improvements, is the exact counterpart of §36a, applicable to private improvements.) It was also stated by the appellant, and conclusively established in the record on appeal, that the assignee had notice that he was to be the recipient of trust funds and, it was argued, the assignee was, therefore, within the *descriptio personae* of the statute. In overruling both arguments the Court of Appeals said, page 225:

> "At the time of the commencement of this action there was a balance due and unpaid to the contractor in the amount of $4,802.90. Those monies were not in the hands of the contractor. Neither were they set aside and appropriated to the contract by the State."

Pages 226-227:

> "* * * Plaintiff alleges * * * it must be given preference * * * on the theory that the balance unpaid constitutes a trust fund in the hands of the State exclusively for the benefit of laborers and materialmen and others specified therein as against such an assignment. We agree with the lower courts that plaintiff cannot maintain its claim."

Pages 228-229:

> "* * * It was a valid common-law assignment and, as such, it gave Fiore preference over the plaintiff in the distribution of the unpaid balance due to the contractor upon completion of the improvement contract since the plaintiff had neither a prior nor subsequent valid lien (cases cited)."

Since the Court of Appeals sustained the validity of the assignment in spite of the knowledge of the

assignee that he was to be the recipient of trust funds, it is obvious that such knowledge by a recipient is immaterial if the funds are received by the recipient directly from the owner of the improvement as was the fact in the *Amiesite* case. If that were not the intention of the Court of Appeals, there would have been no necessity for the Court to emphasize the fact that the funds were not in the possession of the contractor, by its statement, "those monies were not in the hands of the contractor".

Petitioner therefore submits that since a trustee is not specified in the *descriptio personae* of the statute, he is not bound by the trust provisions thereof when, as in this case, the funds are to be received by the trustee in bankruptcy, rather than the contractor. It is not a sufficient answer to state that a trustee is vested with no greater interest than the bankrupt himself, as was said by the Circuit Court in its first opinion. That argument is rendered ineffective by the analogous situation of a conditional vendor who has failed to file a copy of his contract, as required by the New York Law. As between that conditional vendor and his purchaser, the reservation of title is valid. As between the conditional vendor and a trustee in bankruptcy of the purchaser, the reservation of title is invalid and will not be given effect. The result has been justified by reason of the Bankruptcy Act, which affords the trustee the rights of an attaching or judgment creditor. Such a creditor would have paramount rights, even under the decision of *Amiesite Construction Corp.* v. *Luciano Contracting Co.* (*supra*), for the court, there, took the pains to point out, at page 226: "Plaintiff was neither a judgment creditor nor an attaching creditor." The inference is that if the plaintiff were such a creditor, the

court would have held in its favor. The debtor as Trustee, is entitled to the same rights as an attaching or judgment creditor.

POINT III.

Section 36a of the New York Lien Law should not be invoked for the benefit of a materialman creditor who has failed to file a lien within the statutory period.

In its first opinion reversing the District Court, the Circuit Court relied upon a decision of the Appellate Division, Second Department, in *New York Trap Rock Corp.* v. *National Bank of Far Rockaway,* 260 App. Div. 1035, aff'd 285 N. Y. 313, wherein that Court held that the funds received by a contractor do not acquire the character of trust funds unless and until a lien is filed. Subsequently, the case was affirmed by the Court of Appeals on procedural grounds, leaving for future determination the construction and effect of the trust section involved. Because of the refusal by the Court of Appeals to pass upon the Appellate Division's construction of the statute, the Circuit Court reversed its former decision upon the reargument.

Up to the present time, there has been no ruling by the Court of Appeals on this question. However, the question was presented to the Supreme Court of Wisconsin in *Pauly* v. *Keebler,* 175 Wis. 428, 185 N. W. 554, a case involving a statute similar to §36a of the New York Lien Law.

The statute involved states:

> "All monies paid by the owner to the principal contractor shall be and constitute a trust

fund in the hands of such principal contractor, to the amount of all claims due from or owing by such principal contractor, for work, labor and materials or to become due from or owing by such principal contractor for such work, labor and materials to persons entitled to a lien under this chapter against said owner and his property until all such claims have been paid; the using of such moneys by such principal contractor for any purpose other than the payment of such claims, until all such claims, except those which may be in dispute, have been paid, is hereby declared to be an embezzlement of said moneys punishable as provided by law in case of embezzlement."

Referring to this statute, the Court states:

"As we construe the language of the statute, it refers to all persons who may be entitled to claim the benefit of the lien law, but it could hardly have been the legislative's intent that the clause in question should refer to those who have lost their right to claim a lien by neglecting to file any notice within the statutory period. Nor do we think the legislature could have intended that the clause should be construed so strictly as to include only those who had actually filed the notice of lien at the time of the diversion of the trust fund. Such a construction would enable a contractor to obtain money from the owner and misappropriate it before the time for filing notices had expired or before the amount due laborers or materialmen had been ascertained and thus the object of the statute would be defeated."

The interpretation placed upon the statute by the Wisconsin Supreme Court is logical and should be followed.

POINT IV.

In effect, Section 36a of the New York Lien Law grants priority to a class of creditors in contravention of Section 64 of the United States Bankruptcy Act.

Prior to the 1938 amendment, one of the subdivisions of §64 provided for priority on debts owing to a person who, by the laws of the state, was entitled to priority. The provision as to such debts was eliminated by the 1938 amendment.

The intent of Congress in enacting this amendment is expressed in the report of the House Committee on the Judiciary (report number 1409, 75th Congress), wherein it is stated:

> "Elimination of certain priorities: Section 64: Certain state priorities have been eliminated. The necessity for so doing is obvious; many estates have been consumed, to the exclusion of general creditors, by the ever increasing class of state priorities."

It was claimed by the petitioner in the Court below that the effect of §36a was to create a class of creditors entitled to priority in contravention of §64a, subdivision 5, of the Bankruptcy Act. The Circuit Court, in its first opinion, held that §36a did not alter the priorities fixed by §64, since the trust funds were not assets of the bankrupt's estate. No doubt, the Circuit Court was guided by the characterization of trust funds, as used in the statute. If such a characterization is sufficient to remove the funds of a bankrupt from the reach of his general creditors, there is nothing to prevent each state from enacting similar legislation to apply to each and

every industry that may be carried on in the several states. Consistency would demand that the Federal Courts recognize such statutes. The ultimate result would be to revive the very evil that Congress sought to eliminate by the amendment.

The characterization used in a state statute in and of itself should not be the determining factor, as was stated by this Court in *The City of New York* v. *Michael Feiring,* trustee in bankruptcy of National Studios, Inc., decided May 26, 1941. This Court, by Mr. Justice Stone, said:

> "Intended to be nationwide in its application, nothing in the language of §64 or its legislative history suggests that its incidence is to be controlled or varied by the particular characterization by local law of the state's demand. Hence we look to the terms and purposes of the Bankruptcy Act as establishing the criteria upon the basis of which the priority is to be allowed."

When subjected to the foregoing test, it is submitted that §36a contravenes the terms and purposes of the Bankruptcy Act.

CONCLUSION.

In order to resolve the conflict which now exists between the Circuit Courts for the Second and Sixth Circuits, it is respectfully submitted that the writ of certiorari should be granted.

Respectfully submitted,

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